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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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THE MARKET On August 30, the Rail Average pushed fractionally above its May 31, 1963 high — to establish a new high of 176.86 (see chart #1). From that day on, the two Averages parted company. Even as Industrials rose to an all-time high of 745.96 on September 24, Rails dropped steadily lower. On September 31, the carriers broke below their September low -- to the lowest level since early August. Thus, as this Letter is written, Industrials are within a few percentage points of their all-time high, while Rails are within four points of their July (164.88) low.

"When the Averages disagree, " wrote Robert Rhea, "they are shouting 'be careful'." Although divergence in the Averages is not a guarantee of forthcoming danger, it is a fact that almost every reaction and bear market in history was preceded by a period of definite divergence. Moreover, history demonstrates that (except in a few rare instances) a single Average never travels very far without confirmation (at least in direction) by its companion Average. For this reason, veteran market students have learned to "step aside" during periods when the two Averages are "out-of-gear". Furthermore, when divergence occurs following a long advance, and that divergence is accompanied by an area of high volume, the possibility of danger is heightened.

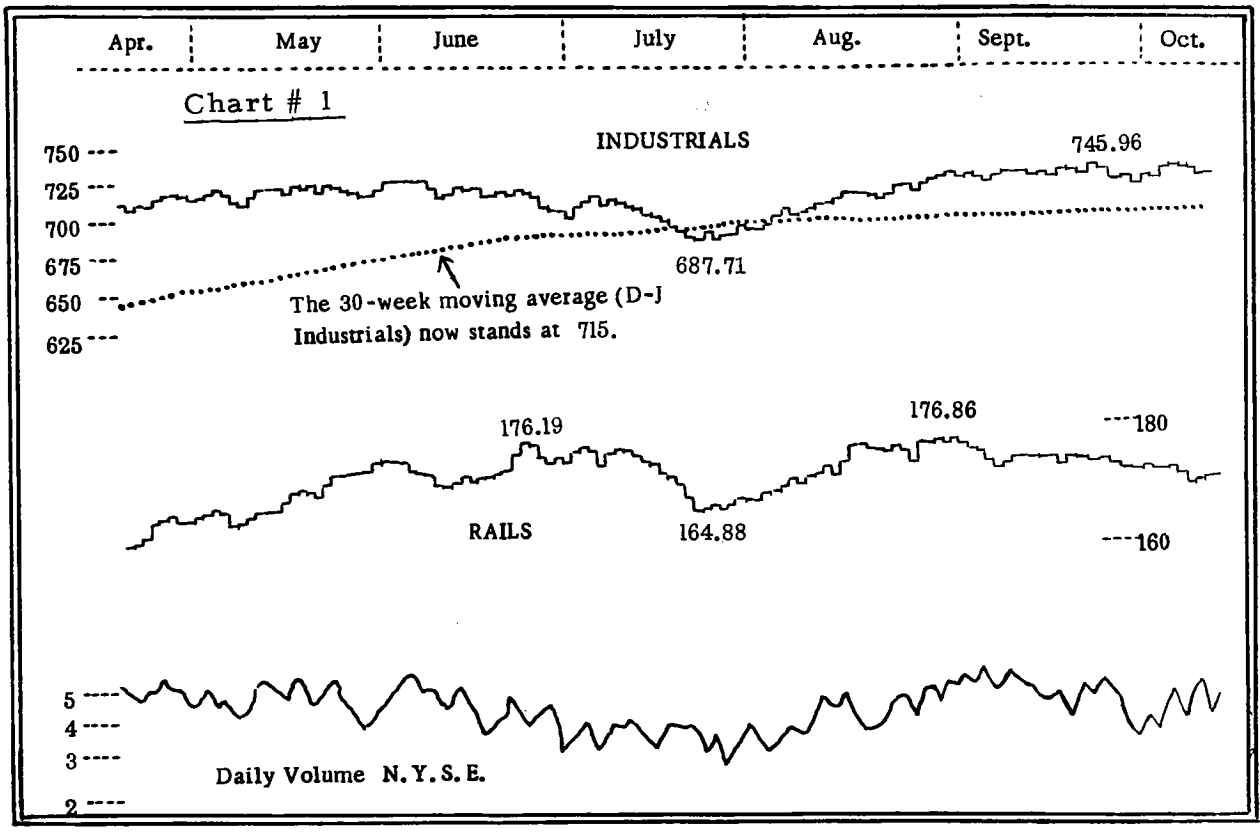
MORE ON DIVERGENCE In Market analysis, the serious student is always trying to relate past experience to the present. Thus, the current critical question is: "What happened when divergences between the Industrial Average and the A-D ratio occurred in the past -- and how can we apply that knowledge to today's market?"

Of the eleven divergences which occurred previously, all but one brought substantial declines in the A-D ratio. The one mild decline in breadth came following the June, 1948, divergence. But even in 1948 the Industrial and the A-D ratio declined gradually to a major bottom which was recorded in June, 1949.

I have included below, a record of the action which followed all past divergences. The date in each case indicates when the divergence was completed:

November 6, 1919: Following this divergence, Industrials went into an extended bear market which took them from a November, 1919 peak of 119 to an August, 1921 low of 63.

September 21, 1929: This divergence was followed by a three-year collapse in price and breadth (a history which is too well known to warrant repeating here).



March 18, 1937: A divergence followed by a sharp decline in price and breadth to a low in June, 1937. A rally followed, which brought Industrials back to within 4 points of the preceding March peak of 194. However, the A-D ratio performed very poorly on the rally. A second divergence occurred near the peak of the 1937 rally on....

August 19, 1937: This divergence was followed by a severe collapse in price and breadth -- ending in early 1938. The 1937-38 "crash" was more drastic than anything seen during 1929-32 from the standpoint of damage incurred within a six-month period.

June 22, 1948: A mild decline in price and breadth carried to September, 1948. This was followed by a good rally, and a renewed decline to major lows established in mid-1949.

May 26, 1956: The A-D ratio began a long decline which was to last until November, 1957. But Industrials, after touching an all-time high of 521.10 in April, 1956, dropped sharply -- then rose to a second peak of 520.95 in August, 1956. Another decline took Industrials to a low of 463 in February, 1957 -- and a third rally got underway. The third rally ended on July 12 with the Dow at 520.77 and the famous "triple Industrial top" was completed. On....

July 29, 1957: Another triple divergence materialized. This was followed by a 100 point decline in Industrials. Thus the A-D ratio had actually "topped out" in May, 1956, but the Industrial Average was able to rally to the 520 level three times against the steadily declining A-D ratio.

May 26, 1959: This divergence was the start of a 17 month decline in the A-D ratio. Nevertheless, the Industrial Average rose persistently against the sinking A-D ratio, touching new highs in August and December. On....

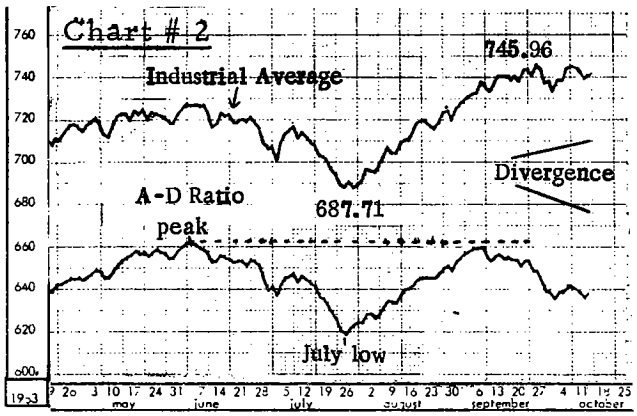
January 11, 1960 another triple divergence occurred only a few days after an all-time high of 685.47 was recorded by the Industrial Average. The January, 1960 peak was followed by a 119 point decline in Industrials to a 1960 low of 566.05.

March 15, 1962: Industrials had recorded a record peak of 734.91 in December, 1961. Three months later the March, 1962, divergence was completed with Industrials at 654.23. The divergence was followed by a collapse to an Industrial low of 535.76 in June, 1962. This was one of the few triple divergences which began well below the peak of the preceding Industrial rise.

What can be learned from the foregoing history? For one thing, we note that in the past when a divergence was completed, it was always followed by important further deterioration in the A-D ratio. Moreover, in only one case (March-May, 1959) did the Industrial Average rise to immediate new highs following a divergence. In other words, in ten out of eleven previous instances, following a divergence, Industrials declined substantially before an important rally finally materialized.

Next, it is worth nothing that following a divergence, it seems to require a major (downside) non-confirmation to supply sufficient technical strength to set off an important rally. Thus, the last Letter traced the path of Industrials and the A-D ratio following the 1959 divergence. In each case, it was seen that the Industrial rallies came after a refusal by the Senior Average to confirm an important downside penetration by the A-D ratio.

From this it follows that if an important or profitable rally is to develop (see chart #2), it should develop after a penetration by the A-D ratio through its July, 1963, low (assuming, of course, that such a penetration is not confirmed by the Industrial Average).



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In order to aid readers in further understanding the price-breadth relationship, I have included chart #3 (page 3) which shows the monthly high and low for Industrials and the A-D ratio from 1947 to the present. I have identified the various divergences which occurred during that period by number; the final bottom which followed each divergence is identified by letter.

Note that in each case following a divergence, price and breadth resolved their "problem" by a single method -- Industrials and the A-D ratio always got back "in gear" through the mechanism of breaking to important lows together.

Thus, divergence # 1 (see chart) in 1948 ended with both indicators dropping to lows in mid-1949 (at point A). Divergences #2 and 3 (1956) and 4 (1957) resulted in new lows for price and breadth in late 1957 (B). Divergence #5 (1959) and #6 (1960) resulted in both indicators breaking below their 1959 range in late 1960 (C). Divergence #7 in 1962 took price and breadth below the 1960 lows in mid and late 1962 (D). It should be remembered, however, that final important lows after each divergence did not preclude profitable intermediate rallies.

Divergence # 8 was just completed on September 23. Whether it will result in a 1956-type extended "top" or a 1962-type collapse no one can know. Based on past history, however, my guess would be that the abnormal relationship (the divergence) which has appeared between price and breadth will eventually be resolved by a movement which takes both indicators below their 1962 lows (i.e., back in gear on the downside).

BUYING AND SELLING PRESSURE (Chart # 4). On September 13 the Selling line rose above the Buying line. As seen on the chart, the two indicators reached their widest spread (and selling pressure its greatest intensity) on October 1. Since then, the lines have moved steadily towards the neutral position, and on October 11, Buying pressure fractionally crossed above Selling again. The September-October decline did not succeed in producing a truly "sold out" condition in the market (such a condition is usually identified when the Selling line climbs to 7000 or higher). I would not expect an important or profitable rally to develop until the market declines sufficiently to produce an oversold condition on the graph.

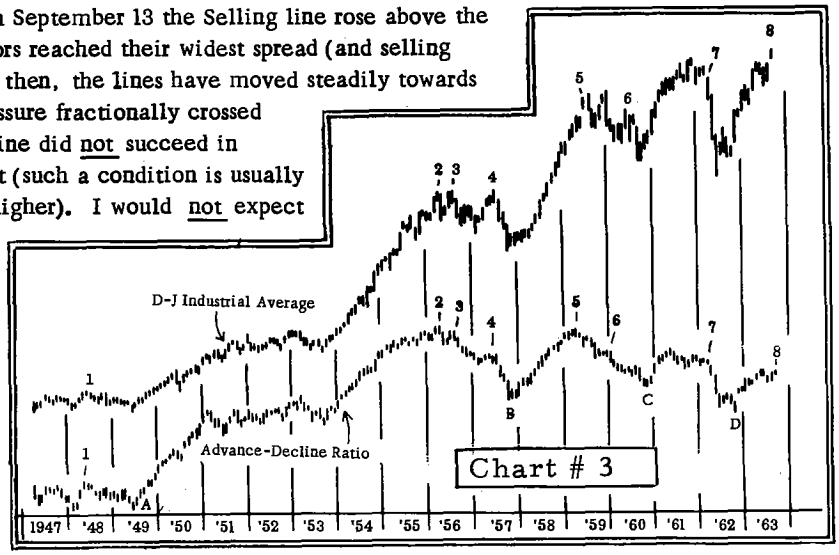
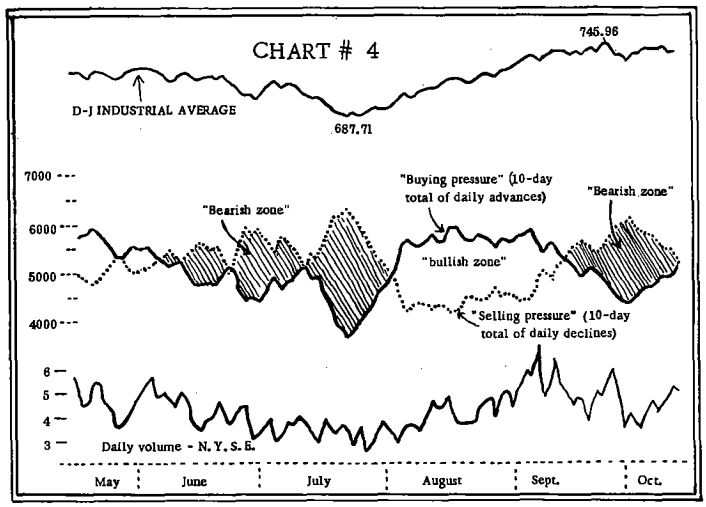


Chart # 3

SUNDRY OBSERVATIONS Markets cannot be hurried. Impatience has probably cost investors as much money over the years as any other single failing. This market has, through the mechanism of an extended period of divergence between Industrials, Rails and the A-D ratio, thrust itself upon the horns of a "technical dilemma". How the market means to resolve this dilemma will be made clear as we go along. Our job now will be (1) to protect our capital while the market problem is being "solved", (2) to attempt to garner profits if and when the opportunity arises.



The technical situation is extraordinary. On the one hand, the price-breadth relationship suggests an important correction ahead. Further evidence of impending trouble is provided by the poor performance of the Rail Average since late May. But against this we note the large short position, the long area of steady odd-lot selling and the record low amount of odd-lot participation as a percentage of total participation. Finally, we observe that N.Y.S.E. margin accounts (debit loans) are holding at record levels of over $5 billion. Speculators are evidently still betting on substantially higher prices.

Could this "technical schizophrenia" produce a "fooler"? Could we witness a general (even "scary") decline -- followed by a "blow-off" in the Industrial Average similar to that which occurred in late 1929 or even early 1930? It is worth remembering that the A-D ratio turned decisively down in late 1928 (at which time the majority of stocks passed their peak of strength). The subsequent 1929 advance was highly selective, and most traders were "sweating" well before the fabled October crash finally materialized. Could such a selective rise be in the cards for late 1963 or 1964? I would not rule it out completely.

But if "fireworks" are to occur in a selected list of stocks, I feel that the action will come via the technical phenomenon of a new low on the A-D ratio (below the July, 1963 low) unconfirmed by the Industrial Average. We will identify the situation if and when it appears.

* * * *

The most consistent phenomenon in the market is the steady deterioration on the American Exchange. Week after week the A-D ratio on that Exchange sinks to new lows (below all other 1962 and '63 lows). Since many people are still "locked in" with losses on the junior Exchange, this is another reason why public sentiment is not improving. A prominent analyst has written that he considers the American Exchange to be "sold out". Maybe, but my statistics don't show any sign of a reversal -- not yet at any rate.

* * * *

In these Letters I have always attempted to present the "reasons why" and the logic behind my market opinions. If some of the studies presented here seem to go too deeply into past history or too intimately into a given method, it is because I insist that subscribers understand all they can about market methods. Knowledge gained regarding the market will always stand the investor in good stead; the "sure-fire" guesses of investment advisors are usually best forgotten.

Furthermore, these Letters attempt to deal with probabilities -- not predictions. I note (particularly in current advertising) the increasing use of the "crystal ball" approach to market analysis. "The Dow cannot possibly go to a new high." "The first week in November will see a cyclical top." "We look for 900 to 1000 in the Industrial Average by 1965." Each year seems to bring forth its market "geniuses" and its "infallible new methods." But veteran market practitioners will not buy the pronouncements of a genius. Moreover, if a true genius could or did exist on Wall Street, he would quickly develop a following which would render his clairvoyance absolutely worthless.

Robert Rhea, as brilliant a market student as ever lived, consistently warned his readers against infallibility and the crystal ball. "Some services are always positive," he wrote. "In the end, they might be right half of the time. They ballyhoo their correct guesses and hush-hush the wrong ones."

Again he noted: "Most investors are familiar with the cocksure type of service which, when followed by the unwary, proves ultimately to lead to disaster. The opinion of almost any intelligent man, if it is independently formed, is a better one than can be expressed by the quacks who claim infallibility as market prognosticators."

STOCKS Of 432 stocks which are tabulated here each week, 302 or 70% are now holding above their 200-day moving average -- an improvement of 5% from the last Letter (tabulations are from Quote Digest, 110 N. Lorraine, Wichita, Kansas).

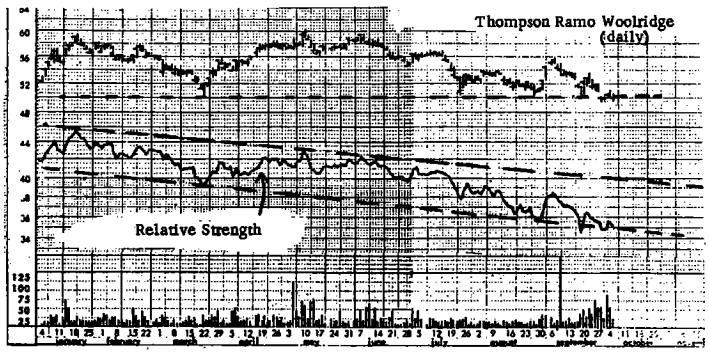
When Wall Street's financial writers are waxing poetic over a group of stocks, it's a fair bet that the group is under distribution (particularly if the group's R. S. line is at an advanced level). The chart below traces the R. S. of the Auto group, this year's recipient of "great news" via record sales and earnings. Note, however, the R. S. in the Auto group has been rising even since mid-1961, and Auto R. S. now stands at the highest level in its history (I have this group's R. S. plotted back to 1912). My guess is that the auto stocks are now in the process of massive distribution, and following this distribution it will probably be years before these stocks return to anything like their present popularity. It takes great news to sustain a huge distribution, and it is well to remember that "today's most popular stocks are tomorrow's forgotten issues."

I do not want to recommend much in the way of trading positions at this time. Long positions (based on strength in the Industrial Average) are now premature. Short positions in selected stocks may begin to work out, but as long as the Industrial Average resists the downside (as it has been doing), short positions will also contain elements of above-average risk.

Although the September-October weakness took the A-D ratio halfway back to its July low (see Chart #2), the Industrial Average is still within a few points of its all-time high. Strongest stocks in the Industrial Average at this writing are: Chrysler, Gen. Motors, Goodyear, Int. Paper, U. S. Steel.

The Oil group is beginning to "crack" on a R. S. basis, and many of these issues now look "toppy". I consider the oil stocks a "sale" at this time, and I doubt that even the leaders such as Standard of California, Jersey, and Texaco will participate in any further advance in the Industrial Average.

I am adding Thompson Ramo (chart below) to the list of stocks which I believe have a good downside potential. TRW has broken the "neckline" of a large "head-and shoulder" top, and is now heading down. As seen on the chart, TRW's relative strength line has been travelling along a pronounced downward channel for many months now, and this "poorer-than-the-market" action has now been confirmed by the price.



Charts on this page courtesy of Traders Research, 1431 Pearl Avenue, Alton, Illinois 62003.